THE DECLINE OF THE DOLLAR: IMPLICATIONS FOR NIGERIA'S FOREIGN RESERVES

Job Pristine Migap
Department of Economics
Kwararafa University, Wukari, Taraba State
E-mail: keffi4942@yahoo.ca

ABSTRACT

Nations rise and fall according to the trends of their economies. For it is the economic growth of a nation that confers on it, its status among the comity of Nations. Since the end of World War II, the American economy has led the world in terms of trade, manufacturing, innovation, finance etc. Hence the American state became the leading nation in the world and the dollar, the de-facto currency most sought after as a means of lubricating trade and storage of wealth. However, over the last decade there has been a gradual slow down in the American economy; growth has petered down and the status of the dollar among international currencies is on the decline. Will the dollar lost its dominant role in international transactions as a reserve currency? This paper notes that it will happen, albeit slowly. Hence, it purports to highlight the demerits of maintaining our external reserves in a single currency (Dollar).Drawing heavily from existing literature on external reserves management and exchange rate, It suggests that the monetary authorities should start a gradual divestment from purely dollar denominated securities to securities denominated in other currencies .Only the optimal level of reserves should be kept by the authorities while the excess should be used for infrastructural development, as well as institute A Sovereign Wealth Funds to manage the revenue from sales of crude oil for future generations; among others.

Keywords: *Dollar, Nigeria, foreign reserves, economy, currency*

INTRODUCTION

The United States' dollar has been effectively playing the role of the world's reserve currency since World War II. The reason for its effectiveness in this regard (and on which the global economy has been founded), has being the strength of the dollar. As a projection of the United States' political, military and financial might, it has been all powerful for more than half a century. As a means of exchange for goods and services the world over, including all commodities and much of international trade, it has seemed unassailable. Now that dominance is coming to an end for financial, economic and political reasons (Neville, 2010). Former Federal Chairman, Alan Greenspan (2006), said 'the dollar is being challenged as the World's reserve currency, with the private sector and monetary authorities as well as Central Banks beginning to move from the dollar to euro.

According to Neville (2010), in 2009 alone, the U.S dollar/euro exchange rate declined from $1.25 to $1.50 and is expected to fall further up to about $1.55 by

the end of the year, 2010. One of the major reasons among the numerous negative influences on the value of the dollar is the huge indebtedness of the U.S government which is currently running a deficit of $12 trillion. Another negative influence on the value of the dollar is a gradual process: it is suffering from a diminishing role as a reserve currency. Excluding the Chinese Central Bank (which does not report its holding to the IMF) only about 40% of global reserves are in dollars compared to 55% a decade ago. With the difference lost to the growing number of Central Banks which are diversifying their foreign currency reserves away from the dollar into the British pound, the euro and the Japanese yen .For instance Switzerland's central bank revealed that it had added yen to its $36 billion in foreign currency reserves and trimmed the share of dollars, while raising its allocation to other currencies. The United Arab Emirates' Central Bank specify that its dollar reserve would be reduce to as low as 50% of the total of $25 billion held. It noted that its reserves were 98% in dollars and 2% in euros (Laidi, 2006).

The foreign reserves (external assets) of a country are of great significance. Every country in the world maintains foreign reserves. It is true to a great extend that the international standing of a currency and its convertibility depend very much on the quantity of foreign reserves maintained by the country. As an ultimate means of settlement of a country's international transactions, foreign reserves enable the balancing of fluctuations between international payments and receipts as they occur from day to day, month to month and from year to year. Moreover they form a fund of international liquidity available for use in the event of unforeseen events such as natural disasters. The availability of reserves, under such circumstances, ensures a smooth flow of goods, and capital into and out of the country, in accordance with needs and practices of trade and commerce. The cushion provided by the reserves also allows time in which to formulate and execute judicious policies to correct imbalances in external transactions when they arise. If the reserves are to play any effective role in this regard, they should be both adequate and usable.

By usable it means they must be kept in the most liquid form. In order to ensure usability most countries maintain external assets in the form of gold, foreign currencies (foreign deposits), and short term government securities. Also, these assets are normally held by, or are under the control of, one institution, which is usually the Central Bank. Thus held, reserves may be quickly put to use if the need arises, and the state of the reserves will always be known to government, so that policies may be adopted or modified to meet the changing external payments position of the country (Stephen & Eghosa, 1978).

Official holdings of foreign reserves derive from attempts by national authorities to maintain fixed rates of exchange between domestic and foreign currencies. In a world where all currencies were backed 100 percent by a single commodity such as gold, or where all exchange rates were freely flexible, every national currency could be used to discharge trading debts in any country. Where rates of exchange are fixed by government fiat, however, or where fiduciary issues

are pegged in relation to other currencies or to gold, different currencies are substitutable as media of exchange only as long as each is freely obtainable at prevailing rates in all countries. The latter condition can be satisfied continuously only if national authorities assume major responsibility for the purchase, sale and holding of foreign currencies and simultaneously pursue policies of economic control that enable them to maintain those rates (Clower and Lipsey, 1968).

According to the IMF(1993),it defines international reserves as "consisting of official public sector foreign assets that are readily available to, and controlled by the monetary authorities, for direct financing of payment imbalances, and indirectly regulating the magnitude of such imbalances, through intervention in the exchange markets to affect the currency exchange rate and/or for other purposes". Such external reserves are usually held by the central banks in non-currency assets, foreign currencies and securities. The non -currency assets include gold reserve, gold tranche and Special Drawing Rights (SDRs) allocated to member countries by the IMF. The foreign currency component comprised of currencies of the major industrialized and trading nations, such as the U.S dollar, pound sterling and euro(& other foreign deposits).While U.S & Japanese treasury securities, bonds and corporate stocks are the main securities component.

Though the management of foreign reserves of a country is the exclusive responsibility of the central bank, the quantum of reserves to be held at any point in time is a function of several exogenous factors such as the prevailing economic management policies and its development objectives (Abeng, 2003).All countries experience balance of payments problems. Some of these are of a short term nature while others era of a fundamental and therefore long term nature. The foreign reserves held by a country will enable her overcome short term problems, but to be able to do this the reserves have to be sufficiently large to absorb the fluctuations between external receipts and payments that might conceivably occur during the short period. Different countries have different types of economies.

A country with a sound industrial base which exports a substantial portion of her industrial output is not likely to suffer from seasonal fluctuations in exports, but this is not the case with most of the developing countries which export primary products. The basic characteristic of such exports is that their movement is seasonal. If a country which depends on the export of primary products holds sufficiently large foreign reserves, she can easily ensure a steady flow of imports without having to wait for foreign exchange earnings from exports. Foreign reserves are of great significance for countries which depend on the export of just a few commodities. This is because crop failure or cyclical variations of the prices in the world markets can lead to disruptions in the flow of imports into the country affected unless it has sufficient reserves to absorb the unexpected shock. The economy may suffer due to loss of revenue or the reduction in revenue caused by falling demand.

The reserves are of great importance to developing countries which have large components in their development plans. When foreign capital does not

materialize, the salvaging of the development plan depends on the extent of available foreign reserves. The absence of reserves, in such circumstances, will make it difficult to import the essential machinery and equipment required for the execution of development projects. In other words, development programmes become vulnerable to all kinds of uncertainties when adequate reserves are not available (Stephen & Eghosa,1978) .

Aizenman and Marion(2003)attributed foreign reserves demand principally to two factors: the first being government's desire to 'smooth consumption'(i.e. to spread out over time, the costs of shocks, such as sudden outflows of international capital when if faces difficulty raising funds either through international capital markets or through domestic revenue sources, and secondly for 'loss aversion'(i.e. the tendency of people in the economy to be more sensitive to reductions in their consumption than to increases).Thus, they perceived demand for foreign reserves as a guard against sudden disequilibrium in planned foreign investments and remittances and also to ensure the maintenance of a smooth continuous level of economic activities.

Husain (2002) stated that reserves are demanded as a tool for exchange rate and policy management. Adequate reserves, according to him, do not only ensure a realistic exchange rate, but also help maintain competitiveness of export goods. In addition Central Bank's ability to intervene in the market with a view to influencing the exchange rate as well as boost the confidence in the currency is principally determined by the level of reserve stock. Countries thus hold foreign reserves to enable them intervene to reduce the volatility or better still maintain a target exchange rate. Thus Husain views the maintenance of a viable and realistic exchange rate of the domestic currency as the driving force for the accumulation of foreign reserves. Jeanne and Ranciere (2006) argue that holding reserves is costly, but without reserves, a sudden stop in capital flows would lead to sharp falls in consumption and output. Their model implies that the optimal level of reserves is a function of the probability of a sudden stop, the output loss in the event of a sudden stop, the level of private external debt to GDP (the roll-off of short-term private debt in their model triggers the fall in output).the term premium and the country's level of risk aversion. A high level of risk aversion, a high risk of sudden stop and large expected output losses all increase the optimal level of reserves, while a rise in the term premium increases the cost of holding reserves and thus reduces desired holdings. This view is basically precautionary in nature in that it sees the reason for reserve accumulation as a guard against a downturn in macroeconomic variables in the short-run.

In the view of Williams (2005), reserves also permit central banks to limit the vulnerability of the country to external shocks, give confidence to the public and reassure credit rating agencies and international financial institutions about the soundness of the economy. Reserves affects the domestic money market balance and, by implication, domestic interest rate through the buying and selling of domestic currency at the inter-bank market. Reserves also provide funds in foreign currencies

for servicing external debts and liabilities. Gradual accumulation of reserves through non-debt creating means to a sufficiently comfortable level avoids panic in the market and precludes the need for contracting additional debt for the country. A high level of reserves provides implicit guarantee to the creditors that the country would be able to meet its obligations when due. For the developed countries, the value of hard currencies is not influenced by the quantum of reserves but rather by economic fundamentals like corporate indicators and capital market movement. William identifies the need to reduce a country's exposure to external shocks, maintaining a credible credit rating with international financial institutions and other indicators of development as the objectives of foreign reserves accumulation.

Acharya(2002) summarizes the major objectives for holding foreign reserves into: a) enhancing capacity to intervene in foreign exchange markets; b) limiting external vulnerability by maintaining foreign currency liquidity to absorb shocks during times of crisis including national disasters or emergencies; c) providing confidence to the markets especially credit rating agencies that external obligation can always be met, thus reducing the overall cost at which foreign exchange resources are available to all the market participants; and e)incidentally adding to the comfort of the market participants, by demonstrating the backing of domestic currency by external assets.

Blackman (1982) classified the main objectives of reserve management into the maintenance of value, income, liquidity, precautionary and political. Most countries would prefer to maintain their reserve assets in currencies that assure relative stability in the international foreign exchange market. The income objective is influenced by risks and returns on holding foreign currencies and securities. Liquidity assures that a reliable level of foreign exchange is maintained that will meet a nation's demand for foreign goods and services. This objective falls within transaction motive of foreign asset management, which tries to ensure a balance between outflows and inflows of foreign exchange. Precautionary motives presuppose that a country holds reserve assets that would guide against total capital losses.

Central Banks worldwide gain from the advantage of being able to invest in foreign money markets, bills, that are highly liquid and interest earning. The CBN in its current reserve management strategies tries to place reserves in securities that are sufficiently liquid (such as the US and Japanese treasury bills etc) to ensure prompt and timely settlement of the country's external obligations while ensuring adequate capital appreciation. Another fundamental issue considered in foreign reserve management is the returns (income) and costs on external reserve assets. Since reserves are denominated in foreign currencies, the holding of foreign reserves therefore implies financing the investments and development objectives of foreign countries by the home country. These reserves thus, constitute an opportunity cost with respect to the goods and services which might otherwise be imported if the reserves were immediately spent. Simple logic therefore suggest that countries do not hold reserves more than necessary, and the reserves should yield a rate of return

which will at least equal the expected utility of their immediate expenditure (oputa, 1997).Ironically, the opposite is the case for most economies, especially the emerging and developing ones, which accumulate foreign reserves much more than the specified thresholds, against all economic reasons or justification. Rodrick(2006),noted that the idea of an excess of low yielding reserves in the developing world represents a radical departure from the problems that were traditionally focused on in thinking about the international financial system. The IMF, on its part, had also expressed concern when developing nations are accumulating reserves to finance the United States (Abeng, 2003).

Stekler and Piekarz's(1970)empirical study revealed the desired gold share in reserve portfolio was influenced by interest earnings on foreign exchange, the risk of devaluation, the adequacy of a country's reserves relative to its transactions needs, and the availability of close substitutes for official foreign exchange. They noted that Central Banks like other investors try to avoid making large capital losses, by divesting from currencies with greater risk of devaluation and holding more of liquid assets. Makin(1971)revealed that official dollar holdings are determined largely by political considerations noting that central Banks do not look, in the first place, at the attractiveness of reserve assets to earn higher income or returns but rather on the on the necessities of international financial cooperation or non- cooperation. Ben-Basset (1984), noted in his study that a country's optimal reserve composition is influenced by three principal factors: the country's motive for holding foreign currency reserve, the risk and returns on the various currencies and the country's interest in maintain international monetary stability.

Basset (1984) further noted that for countries with floating exchange rate systems whose currencies serve as reserve assets for other central banks, their reserves are likely to be influenced by international monetary stability than for profit and loss considerations. But or most countries with pegged exchange rate regimes, and in particular developing countries and semi-industrialized countries, the composition of their reserve currencies depends mainly on the profit ,risk and liquidity considerations. Thus, the basic idea in the theory of the demand for foreign reserve is that a country chooses a level of foreign reserve to balance the macroeconomic adjustment costs incurred if reserves are exhausted, with the opportunity cost of holding reserves (IMF, 1993).

RESERVE MANAGEMENT

Foreign reserves management is a process that ensures that adequate official public sector assets are readily available to and are controlled by the authorities for meeting a defined set of objectives. Such objectives should seek to ensure that: (1) adequate foreign exchange reserves are available for meeting a defined range of objectives; (2) liquidity, market and credit risks are controlled in a prudent manner; and (3) subject to liquidity and other risk constraints, reasonable earnings are generated over the medium to long term on the invested funds (IMF, 2004).

The main objective of the management of the external reserves by the CBN as

stipulates in the CBN Act 2007 is to maintain external reserves at levels considered by the Bank to be appropriate for economic and monetary system in Nigeria. External reserves management objective therefore, can be categorized into preservation of capital, maintenance of adequate liquidity and the maximization of return within a tolerable risk limit. To preserve capital, the CBN invests the external reserves mainly in government securities such as treasury bills, bonds, and in foreign banks with high credit quality. The bank ensures that adequate liquidity ratio is sustained to promote timely intervention, finance daily transactions and other financing that may be required as well as earn returns that can sustain its operating cost.

In Nigeria, over 85.0 percent of external reserves is realized from the oil sector, derived from the sale of Nigeria's crude oil equity by the Nigerian National Petroleum Corporation (NNPC), and royalties paid by oil companies arising from the commercial exploitation of the nation's oil resources as demanded by the petroleum Act of 1969, Petroleum Profit Tax (PPT), penalty for gas flaring, rentals, signature bonuses and receipt for gas sales. The balance is accounted for by non-oil export earnings and returns on investments abroad (CBN, Briefs, 2009).

Nigeria's external reserves, in terms of ownership, consist of three components: the Federation, Federal government and the CBN. The Federation component consists of sterilizes funds (unmonetized) held in the excess crude and the PPT/Royalty accounts at the CBN, belonging to the three tiers of government. This portion has not yet been monetized for sharing by the federating units. It is sometimes ignorantly referred to as the reserves of the country. The federal government component comprised of foreign exchange belonging to some government agencies such as NNPC; used for financing Joint Venture Cash call payments, infrastructural developments and government's letter of credit. The CBN portion is that which had been monetized and shared between the three tiers of government by the Federation Account Allocation Committee (FAAC) as stipulated by the constitution and the revenue sharing formula. This arises as the Bank receives foreign exchange inflows from crude oil sales and other oil revenues on behalf of the government. Such proceeds are purchased by the Bank and the Naira equivalent credited to the Federation account and shared. The monetized foreign exchange thus belongs to the CBN. It is from this portion of the reserves that the Bank conducts its monetary policy and defends the value of the naira. (www.cenbank.org, 2006)

Before independence, Nigeria's assets were held by various statutory corporations and private institutions. They were scattered among various official and semi official bodies like the marketing boards, and were held mainly in the form of foreign government (mainly British Government) securities. Efforts to mobilize and centralize the foreign assets started immediately after independence. In 1961, the Central Bank of Nigeria with the cooperation of the Ministry of Finance succeeded in bringing the assets held by government and quasi- government bodies into one central pool. In 1962, the Federal Government converted virtually all its assets invested in long term foreign securities into a more liquid form. Statutory corporations

and private institutions were directed to reduce their foreign holdings. The total assets repatriated to Nigeria in 1962 amounted to N20 million (£10m).The repatriated funds ere invested in Nigerian Government securities. Also in 1972, the government transferred the country's gold holdings totaling N14.2m (£7.1m) to the vaults of the central bank of Nigeria. This move was aimed at maintaining adequate level of reserves to support the country domestically and abroad (Stephen & Eghosa, 1978). In 1974, the CBN diversified from holding high proportion of its reserves in pounds sterling into seven currencies (US Dollar, Pound Sterling, Deutsche Mark, Canadian Dollars, Swiss Franc, French Franc and the Japanese Yen).To increase the earnings from investments, an Investment Management Committee was constituted to oversee the management of the reserves from 1974-1976.Reserves were further diversified into fifteen different currencies in addition to investments in bonds and treasury bills. The currency composition was not reflective of the trading partner, but to preserve the purchasing power of the reserves.

Trade and Exchange Control strategies aimed at curtailing outflows of foreign exchange in order to allow for build up of reserves were applied in varying measures of intensity until 1986 when the second tier foreign exchange market was introduced. This was a component of the Structural Adjustment Programme (SAP) meant to achieve a unified market-determined exchange rate for the naira and ensure optimal foreign exchange utilization. The Bank in 2003 joined the World Bank's Reserves Advisory management Programme(RAMP) to build capacity in reserve management. It appropriated a part of the external reserves to the World Bank to manage at a fee. The Bank benefitted from capacity building for funds managers under this management.

The banking sector reforms of 2005 resulted in the emergence of 24 banks each with a minimum capital base of N25billion.This created the opportunity for local banks to partner with foreign banks and asset managers in the management of part of the nation's external reserves. In the same year the CBN appointed fourteen external fund managers for the professional management of the external reserves with the objectives of diversifying investment and leveraging on the expertise of the foreign banks in the quest to transform Nigerian banks into global financial institutions. The CBN hitherto kept external reserves as deposits with foreign banks. The initiative was in line with global best practices.

ASSETS MANAGERS	NIGERIAN BANK PARTNERS
BNP Paribas asset Management	Intercontinental Bank Plc
Black Rock Inc	Union Bank of Nigeria Plc
JP Morgan Asset Management	Zenith Intercontinental Bank Plc
HSBC Investment (UK) Ltd	First Bank of Nigeria Plc
UBS Global Asset Management	United Bank for Africa Plc
Credit Suisse Asset Management	IBTC Chartered Bank Plc
Morgan Stanley Investment Management	Guaranty Trust Bank Plc
Fortis Investment Management	Bank PHB Plc
Crown Agents Investment Management	Diamond Bank Plc
Investec Asset Management	Fidelity Bank Plc

ABN Amro Asset Management	Access Bank Plc
Cominvest Asset Management	Oceanic Bank Plc
ING Investment Management	Ecobank Nigeria Plc
BNY Asset Management	Stanbic IBTC Bank Plc

Source: CBN Bulletin, 2009

To further ensure a more efficient external reserves management, the bank in 2007 diversified the external reserves to include US Treasury notes and Medium Term Instruments(MTIs) of the Bank for International Settlements (BIS),while special guidelines for deposit placement with subsidiaries/offshore branches of Nigerian banks were issued. The Bank also modernized its technical infrastructure to improve its competence in reserve management; hence it embarked on the construction of a modern dealing room equipped with Bloomberg and Reuters's 300 Extra information system, Portfolio Management System; and Reuters Dealing 3000 system for trade execution. The global financial crisis in 2008 resulted in decrease in returns on the Bank's reserves, however the principal remained intact. The Bank's policy on partnership agreement with foreign asset managers also recorded success in capacity building for the Nigerian counterpart (CBN, Briefs, 2009).

Above all, the essence of all these is to situate the Nigerian foreign reserves management within the context of persistent external shocks arising from instability in the international oil market, taking into consideration the over dependence of the economy on oil, weak financial markets and the attendant macroeconomic stabilization problem on the domestic economy. More importantly given that oil is a wasting asset and the frantic efforts by the highly industrialized countries to search for alternative sources of energy, the new thinking among forward looking countries is in the direction of using foreign reserves as Sovereign Wealth Funds (SWFs).

SWFs are government owned investment funds set aside for variety of macroeconomic purposes. SWFs could be seen as savings, which helps to transfer proceeds from non-renewable resources as oil to future generations. It is a macroeconomic management of accumulated foreign assets in a fashion that strikes a balance between spending from the reserves for current consumption for the present generation and maintaining sizeable reserves as savings for future generations when proceeds from such non-renewable resources begin to dwindle in supply.

These SWFs could be instituted for different purposes accordion to the objective for setting it up. It could serve as stabilization funds, to insulate the budget and the domestic economy against swings in commodity prices. It can be for the purpose of Savings Funds for future generation, in which case, accumulated foreign assets would be moved into more diversified portfolio of assets to minimize the effect of Dutch disease or resource curse. SWFs may be in form of Reserve Investment Corporation to enhance return on reserves. SWFs may be in terms of Development

Funds for the purposes of improving socio-economic projects aimed at achieving high and faster growth of the economy. SWFs may be kept for the purposes of meeting certain Contingent Liability standing on the government's balance sheet such as foreign debt, accumulated pension arrears etc (CBN, Bulletin, 2009)

Table 2: Nigeria's Foreign Reserves (1960-2009)

Year	Assets Naira (₦Billion)	Exchange Rate N/$1	Assets Dollar ($ Billion)	Reserve Adequacy[2] (Months)
1960	N34,270	0.3571	$0.96	1.8
1961	N30,432	0.3571	$0.85	1.7
1962	N24,822	0.3571	$0.70	1.6
1963	N18,792	0.3571	$0.53	1.5
1964	N16,940	0.3571	$0.47	1.3
1965	N18,640	0.3571	$0.52	1.5
1966	N16,880	0.3571	$0.47	1.3
1967	N07,780	0.3571	$0.22	1.0
1968	N09,300	0.3571	$0.26	1.1
1969	N15,160	0.3571	$0.43	1.3
1970	N36,548	0.3571	$1.0	1.9
1971	N30,313	0.3571	$0.85	1.7
1972	N27,060	0.3571	$0.76	1.6
1973	N43,839	0.7143	$0.61	1.5
1974	N3.540,90	0.7143	$5.0	6.0
1975	N3.702,70	0.7143	$5.18	6.2
1976	N3.082,66	0.7143	$4.32	5.7
1977	N3.033,90	0.7143	$4.25	5.5
1978	N1.349,30	0.7143	$1.89	1.3
1979	N3,250.80	0.7143	$4.55	4.4
1980	N5.648.2	0.5665	$9.97	8.3
1981	N2,441,6	0.6100	$4.0	3.4
1982	N1,043.3	0.6729	$1.55	Less 1 month
1983	N7,985	0.7241	$1.10	Less 1 month
1984	N1,096.8	0.7649	$1.43	Less 1 month
1985	N1,657.9	0.8938	$1.86	Less 1 month
1986	N4,460	2.0206	$2.21	1.8
1987	N6,870	4.0179	$1.71	1.0
1988	N327	4.5367	$0.072	Less 1 month
1989	N23,727	7.3916	$3.21	4.1
1990	N41,320	8.0378	$5.14	6.1
1991	N44,097	9.9095	$4.45	5.9
1992	N39,390	17.2984	$2.28	1.4
1993	N29,322	22.0465	$1.33	2.4
1994	N36,289	21.8861	$1.66	3.0
1995	N101,323	70.3632	$1.44	2.1
1996	N529,424	69.8449	$7.58	7.6
1997	N853,831	71.7505	$11.9	9.6
1998	N209,136.2	84.84	$2.47	1.9
1999	N495,882	91.83	$5.4	6.2
2000	N1,090.33	101.90	$10.7	9.8
2001	N1,119.00	111.90	$10	9.0
2002	N927.85	120.50	$7.7	7.4
2003	N978.75	130.50	$7.5	7.2
2004	N2,269.5	133.5	$17.0	13.6
2005	N3,687.207	130.29	$28.3	18
2006	N5,547.00	129	$43.0	26.8
2007	N6,463.8	126	$51.3	41
2008	N6,301.7	118.9	$53.0	42
2009	N6,310.38	148.9	$42.38	25

Source: Annual Report and Statement of Account CBN, various issues.
Economic and Financial Review CBN, various issues,

1i. as from 1986-2009 exchange rates used for conversion were derived from weighted average of official & AFEM(Autonomous Foreign Exchange Market are rates used for non-governmental transactions)rates.

ii. Prior to 1986 official average exchange rates were used for the conversion.

2. it measures a country's level of trade exposure, signifying the vulnerability or ability of a country to continue to finance its imports, for a certain period of time, usually 3-4 months should there be an unexpected decline in its exports or reserves.

COMPOSITION OF FOREIGN RESERVES

The currency diversification of external reserves involves the shift on the part of Central Banks from holding their external reserves in the traditional gold reserve assets to a basket of foreign currencies and securities. In considering the basket of foreign currencies to hold, the monetary authorities of most countries are influenced by historical, economic and political fundamentals. Although a general economic objective of currency composition of reserves is investment in foreign currencies and securities by central banks to maximize returns on financial resources, the monetary authorities, more often than not, play down on the profitability aspects and concentrate on their liquidity needs especially if they are experiencing balance of payments disequilibrium.

Legislation at the inception of the Central Bank of Nigeria (CBN) made it relatively impossible to diversify the reserve assets away from gold (10%) and the pounds sterling (90%).The dollar assets did not even qualify as part of the official reserve holdings till the amendment of the CBN Act in 1962.Consequently, in the 1960's the external reserves of the country were held predominantly in pound sterling assets thereby conforming with the arrangement of the Sterling Exchange System. The pound sterling accounted on the average for 78.4% of the external reserves from 1959 through 1970 while the US dollar assets accounted for 12.5% in the period. The composition of external reserves in Nigeria as indicated under the Banks and Other Financial Institutions Act (BOFIA) 1999 and the CBN Act 2007(section 24) include:

a. Gold coin or bullion.

b. Balance at any bank outside Nigeria where the currency is freely convertible, currency and in such currency, notes, money at call and any bill of exchange bearing at least two valid and authorized signatures and having a maturity not exceeding ninety days exclusive of the days of grace.

c. Treasury bills having maturity not exceeding one year issued by the government of any country outside Nigeria whose currency is freely convertible.

d. Securities of, or guarantees by, a government of any country outside Nigeria, whose currency is freely convertible, provided such securities shall mature in a period not exceeding 10 years from the date of acquisition and are of

such investment grade as may be determined by the Board of Directors of the bank from time to time.

e. Securities of, or guarantees by, international financial institutions if such securities are expressed in freely convertible currencies, in the form of investment grade assets as may be determined by Bank's Board and maturity of the securities shall not exceed five years.

f. Nigeria's gold tranche at the International monetary Fund.

g. Allocation of the Special Drawing Right (SDR) made to Nigeria by the International Monetary Fund.

h. Investments by way of loans or debenture in an investment bank or development financial institution within or outside Nigeria for a maximum period of 5 years in as far as: i. The amount is not more than 5 per cent of the total foreign reserves; ii. The reserve level at the time of investment is more than such amount as will sustain 24 months of imports;

iii. The loan or debenture is denominated in foreign currency provided the investment bank or development financial institution referred to in(h) above, carries such a rating by rating agencies as may be prescribed from time to time by the Bank; and

iv. Such other securities and investments as may be approved from time to time by the Board, provided they are liquid foreign currency assets that are of investment grade and in the form of freely convertible currencies (CBN, Briefs, 2009) .

The central bank presently holds the country's foreign reserves in major currencies such as: the U.S dollar, the euro, the Japanese yen, the British pound, the Swiss franc and those of other trading partners. However, over 90% of Nigeria's foreign reserves is denominated in the U.S dollar, mainly due to the fact that its crude oil exports are invoiced in the U.S dollar while most of its obligations such as external debt service, foreign exchange intervention, as well as other service obligations are also denominated in the U.S dollar (Nda,2006).

The literature reviewed indicates that the main determinants of currency composition of foreign reserves were expected to be the rate of returns, risk of devaluation, transaction needs/international trade, adequacy of reserves, denomination of foreign debt and political considerations.

An empirical study on the "Determinants of Currency Composition of Nigeria's Foreign Reserves" was undertaken by Oputa (1997),using a model which assumes that(i)foreign reserves in Nigeria are held in a basket of five major convertible currencies, viz. British pound sterling, United States dollar, German deutsche mark, Japanese yen and French franc, corresponding with the currencies of her principal trading partners, However, all other foreign currencies were grouped together.(ii)the measurable variables for establishing the determinants of currency composition are exchange rate and interest rate which proxy, respectively, the risk of devaluation and the rate of return on investments, while exports plus imports to major trading partners

measure the quantum of trade flow or transaction/liquidity motives.(iii)reserve adequacy represents the level of reserve that could support four(4) months of current import commitments.(iv)political factor was based on the fact that in most of the 1960s to the mid 1970s,Nigeria's foreign reserve were tied to the pound sterling.

International Trade: The result shows that the effect of international trade on the currency composition of Nigeria's foreign reserve was insignificant with a low explanatory power (R^2) of only 35%. However, a disaggregation (breakdown) of the variables reveals that exports receipts from international trade had more influence on the foreign reserve composition than imports. It accounted for 73% compared to 33% for imports. This is not surprising, since a grater proportion of Nigeria's receipts from international transactions is from oil, denominated in dollar, which further made it easier to settle external commitments to other trading partners in that currency.

Interest and Exchange Rates: The impact of interest and exchange rates on the foreign reserve composition was very poor with an explanatory power (R2) of only 45% and 42%.Which shows that safety rather than returns on investment was the driving force in Nigeria's foreign reserve management policy.

Currency Composition of External Debt: The explanatory power (R2) of the currency composition of foreign debt in the model was high at 79%.The independent variables performed favorably with debts denominated in pound sterling, dollar & deutche mark influencing the dependent variable. This reveals that the composition of Nigeria's external debt has a tremendous impact on the currency composition of its foreign reserve.

Reserve Adequacy: The effect of reserve adequacy on the foreign reserve composition was significant with the appropriate sign in the model. It has an explanatory power (R^2) of 43% which is quite impressive as it identifies reserve adequacy as one of the determinants of reserve currency diversification.

Political Consideration: The impact of political consideration in the reserve currency diversification was very low at 23% and with negative sign. This is in line with the current management strategy embarked upon by the CBN (for with the exception of the pre-independent era, when Nigeria's currency was tied to the British pound and all foreign reserves were held in British government securities)which tends to manage the country's reserves in line with global economic considerations and management practices.

IMPACT OF CHALLENGES FACING THE AMERICAN ECONOMY ON THE NIGERIAN ECONOMY

Since the Second World War, the dollar has been the currency used most commonly in financial, trade, and cash transactions worldwide. Whether that will remain the case is the subject of an intensifying debate in global financial circles. Already, the euro is counted as the dollar's dominant challenger, while China's central bank governor, among others, has suggested establishing an alternative (some might

say, rival)"super-sovereign reserve currency" (Hellerstein & Ryan, 2010). Apart from the actions of Central Banks, the amount of global trade conducted in dollars is also a strong indicator in determining the role of the dollar as a reserve currency. The convention of using the dollar to price trade and commodities is a reflection of the U.S economy's dominant position following World War II (just as the Sterling played a similar role in the late 19th and early 20th centuries).According to Minikin (2010), there are trade corridors developing within Asia, which does not include the U.S. and therefore it no longer makes sense to denominate everything in dollars. For example there have been several discussions between Chinese and commodity producers in the Middle East and Brazil about using alternatives to the dollar, such as the euro, and to a lesser extent the (Chinese) renminbi, or possibly using the IMF Special Drawing Rights (SDRs).

Will the dollar inevitably decline and fall? And if so, how quickly? Will we witness a rapid coup (in currency time) occurring over the next ten years, as some commentators believed? Or will we see a much more gradual process owing to the built-in inertia of the dollar's prominent role? (Chinn & Frankel, 2008). While America will likely remain the world's largest economy for years to come, it is not inevitable that the standard of living of most Americans will continue to increase as it did, for instance, in the years following World War II. What is worrisome is that with the amount America has been borrowing from the rest of the world (the US government was borrowing as much as 6% of GDP from other countries), more than$800 billion in 2006 alone, its borrowing could not be sustainable. There could be a disorderly unwinding of these imbalances, with possibly large disruptive changes in exchange rates (Stiglitz, 2010).

Although the current financial problems ignited in America have led to a global meltdown, it will take more than that to topple America from its current role. Because a reserve currency is not decided upon; it creates itself. Creating another World currency requires several factors to be in place. Economic literature has identified five major factors that could facilitate the emergence of a currency as a reserve currency. These include (i) large economic size (ii) well-developed financial market (iii) confidence in the currency's value (iv) political stability and (v) net externalities. Reserves currencies are typically linked with large competitive economies, mainly those with extensive trade and financial ties. Such an economy will usually generate a large market in foreign exchange transactions with at least one strut in its own currency. Large market size has a tendency to effect lower transactions costs, reflecting economies of scale in financial resource management (Onwioduokit, 2008). The U.S is the only economy that potentially could qualify. Reserve currencies are generally linked with open, liquid and well-developed financial systems. That requires a central bank with an enormous amount of autonomy from a state government, and the U.S Federal Reserve is unparallel on this count. Not even the European Central Bank can compete (Mcneely, 2009). Presently the dollar is backed by the deep, liquid, and well diversified financial markets in New York. A

well developed financial system enhances the attractiveness of the domestic currency. It provides deep and liquid secondary markets for securities to global market participants, who do not usually hold their international money in the form of currency balances, but as an alternative, need liquid interest bearing assets of a short-term risk free instrument, to hold their temporary positions (Onwioduokit, 2008).

Reserve currencies are also held as stores of value, such as short term instruments, working balances, international bonds etc. Consequently a reserve currency must be perceived as sound, with stable future value in terms of goods and services it can command. Volatility in value raises holding risk, and inflation obliterates purchasing power. The prevalence of these elements would discourage investors from holding assets in that currency. Friedman (1971), opined that no exchange medium can survive if it is not also a store of value (although the converse does not necessarily hold).Confidence in a currency's value is also imperative indirectly for its medium of exchange function. The dollar has been above averagely stable for the past six decades, thereby instilling confidence in central banks of several countries and financial institutions.

Political stability is specially underscored by most economists. Mundell (1998) noted that 'when a state collapses, the currency goes up in smoke.' He emphasized the strong chronological link between reserve currencies and strong central states, because strength implies political stability, which also facilitates the pursuit of monetary stability. Net externalities, a trend associated with reserve currencies whereby a good or service becomes more valuable as more people use it has been identified as one of the factors that facilitates the emergence of a reserve currency.Net externalities are efficiencies because they increase average revenue (or demand) with scale, in contrast to the technical or supply-side economics, which decrease average cost with scale (Varian, 2003). The dollar has maintained the role of international reserve currency over the years, despite substantial fluctuations in its exchange value, because the size, sophistication, and relative stability of the U.S economy generally render the costs of transacting in U.S dollars lower than the costs of transacting in currencies that do not equally share these characteristics.

In large part, the widespread use of the dollar developed and continued because the US has been the largest, most broad based exporter and importer in the world. With a lot of Americans trading globally, a lot of dollars naturally changed hands. Because traders must finance a large portion of their business in US dollars, they maintained accounts, seek loans, and undertake myriad other financial arrangements in dollars. A strong and open US financial system facilitates the dollar's international use. While a high degree of feedback naturally exists between the dollar's expanding role in trade and the growth of an accommodating financial structure, US financial markets have always been innovative and relatively free of cumbersome regulations. Their breadth and depth enhances the liquidity of dollar denominated assets. Moreover, as dollar trade expands and US financial markets grow, more and more foreign financial firms, including those not located in the US, offer dollar-denominated

products. This makes holding dollars convenient and transacting in dollars relatively easy. As the global network for dollars expands, the benefits of using the dollar in exchange rise. The process is self-reinforcing. Moreover, once the network benefits of a particular currency become substantial, people are prone to continue using it, even if viable competitor exists (Onwioduokit, 2008).

Despite these advantages, the dollar's fate as a reserve currency looks sealed with no resurgence likely in the long term. Undoubtedly, there will be bouts of recovery and corrections during periods of high risk aversion, or a strong performance by US equities could prompt inflows that bolster the position of the dollar. However, it is extremely unlikely in the foreseeable future that the US dollar will get back its position of strength globally.

Although accumulation of reserves adds confidence, over accumulation in a single currency can in itself bring vulnerability. It is argued that massive U.S payments deficits are beginning to undermine confidence in the dollar and for large dollar holders there may be a point beyond which there is over exposure to the dollar and therefore vulnerability can set in(Williams,2005).A large proportion of Nigeria's foreign assets are denominated in dollars. A fall in the value of the dollar would have several negative impacts on our foreign reserves. Some of which are:

1. It will lead to a fall in (real terms) in the value of our foreign reserves. I.e. the purchasing power of our nominal dollar denominated reserves will be greatly reduced, thereby limiting our ability to implement certain policies and finance several developmental projects as well as honouring our international financial commitments to other countries and organizations.
2. Being an economy that relies predominantly on one major source of foreign exchange earner (oil), whose price is internationally determined by the world market and denominated in dollars, a decline in the dollar value means a reduction in our foreign earnings. And since we are an import - dependent nation, it will result in severe balance of payments problems, thereby hampering our economic growth.
3. Since most of our external debts are denominated and amortized in U.S dollars, a depreciation of that currency will result in a larger amount of dollars needed to amortize a given loan. And coupled with the reduced earnings the consequences on the economy would be grave.
4. A depreciation in the value of our dollar reserves will limit the ability of the CBN to intervene in the foreign exchange market in order to maintain the exchange rate of the naira.
5. It will have adverse effect on our credit rating with the international community and financial institutions which will affect our ability to source for foreign capital and loans.
6. Huge dollar holdings of foreign reserves are usually perceived as a sign of good governance. A decline in the value of these holdings will reflect negatively on the government as it would be seen as a sign of mismanagement and likely to undermine its performance at the polls during elections.

CONCLUSION AND RECOMMENDATIONS

The intention of this study was to highlight the possibility of a decline in the value of the U.S dollar and its role as a reserve currency, and the likely impact on the Nigerian economy, and to proffer suggestions on how to militate against the harsh consequences of such an eventuality. It is imperative that the monetary authorities start a gradual divestment from purely dollar denominated securities to securities denominated in other international currencies(based on the currency strength & interest rate obtained),to maximize returns on its investments in the international money and capital markets. The currency composition of our foreign reserves should be reflective of our changing international trade patterns, debt obligations and other external payments to guard against the vicissitudes of the foreign exchange market. Since an appreciation of the domestic currency (naira) usually has a devastating effect on the value of foreign reserves whether denominated in dollar, euro, yen or pound sterling, our foreign reserves should be maintained at the optimal level using the Greenspan-Guidotti criteria which calls on developing countries to amass reserves equal to all external debt coming due within the next year. This benchmark is more relevant than the import adequacy criteria being used by the monetary authorities.

The resources used to purchase international reserves could be used by the monetary authorities to amortize our sovereign short term external debt, since the interest cost of a given amount of short term external debt(though difficult to measure),likely exceeds the earnings on an equivalent amount of reserves. Paying down sovereign short term external debt therefore has an equal vulnerability-reducing effect to holding reserves when following a Greenspan-Guidotti rule, with a lower net cost (Green & Torgerson, 2007). The government could also spend the reserves on investment projects, with the proviso that reserves cannot be converted back into domestic currency if the authorities wish to avoid an impact on the exchange rate. For example, reserves could be used to purchase foreign medical supplies or equipment. Since we have a lower capital-to-labour ratio than the industrial countries in whose bonds reserves are held, the returns from public investments may be significantly higher than current earnings as long as they are allocated effectively (Green & Torgerson, 2007).

Conclusively, it is imperative that the three tiers of government that constitute the federation (Federal, State and local Governments) should totally buy-in into the Sovereign Wealth Funds initiative (Fund for Future Generations) for it to be successful. A legislative backing through an appropriate constitutional provision is also essential to ensure that the uses of the SWFs (mentioned in part iii) can be adopted as relevant options in the Nigerian macroeconomic management. Indeed, given the present microeconomic challenges and the need to take the interest of future generation given that oil is a wasting asset. It would not be a bad idea if adopted in the interest of posterity.

REFERENCES

Abeng,M.O. (2007). Foreign Exchange Reserves Accumulation: Implications for the Nigerian Economy. Central Bank of Nigeria, *Bullion*, 31, 3, July-September.

Acharya, S. (2002). India's Foreign Exchange Reserves: When is enough-Enough? New Delhi: Panel Discussion.

Aizenman, J. and **Marion, N.** (2003). Foreign Exchange Reserves in East Asia: Why the High Demand? Federal Reserve Bank of San Francisco Economic Letter, Number 11.

Ben-Bassat,A. (1984). *Reserve-Currency Diversification and the Substitution Account*. Princeton University: International Finance.

Blackman, C. (1982). *Managing Foreign Exchange in Small Developing Countries.* New York: Group of Thirty.

Banks and Other Financial Institutions Act (BOFIA) (1999). Composition of External Reserves.

CBN: Reserves Consumption & Future Savings: What Options.*www.cenbank.org/IntOps/2006.*

CBN Bulletin (2009). The New Central Bank of Nigeria.

CBN briefs (2009). Management of External Reserves in Nigeria. Series No.2008-2009. Research Department.

CBN Act. (2007). External Reserves Management.

Chinn, M. & **Frankel, J.** (2008). Why the Euro Will Rival the Dollar. International Finance. Vol. 11, 1.

Clower, R. and Lipsey, R. (1968). The present state of international liquidity theory. *The American Economic Review,* 58 (2), 586.

Friedman, M. (1971). The Euro-Dollar Market: Some Principle. Federal Reserve Bank of St.Louis, July.

Greenspan.A. (2006). Central banks still shifting from dollars. Global Finance December.

Green, R. and **Torgerson, T.** (2007). Are High Foreign Exchange Reserves in Emerging Markets a Blessing or a Burden? Department of the Treasury: Office of International Affairs. Occasional Paper No.6.

Hellerstein, R. and **Ryan, W.** (2010). Memory and the dollar: New evidence on international demand. *www.vox-research based network, February.*

Hussain I. (2002). Why Foreign Exchange Reserves?: Ideas and Identities of India -Pakistan. *http// www.chowk.com.*

IMF (1993). *Balance of Payment Manual* (Fifth Edition). International Monetary Fund.

IMF (2004). *Balance of Payment Manual: Foreign Reserves.* International Monetary Fund.

Jeanne, O. and **Ranciere, R.** (2006). The optimal Level of International Reserves for Emerging Market Economies: Formulas and Applications. *IMF Working Paper,* WP/06/229.

Laidi, A. (2006). Central Banks still Shifting from Dollars. Global Finance Dec.

Makin, J. H. (1971). The Composition of International Reserve Holdings: A Problem of Choice Involving Risk. *American Economic Review,* 61, December.

Mcneely, D. (2009). Could the Dollar Fall?. *www.World News & Prophesy, June.*

Minikin, C. (2010). Looking Ahead: The Dawn of A New Decade. *Global Finance January,*

Mundell, R. A. (1998). What the Euro Means for the Dollar and the International Monetary System. *Atlantic Economic Journal,* 12, 3 (September)

Nda, M. (2006). Effective Reserve Management in Nigeria in Nigeria: issues, Challenges and Prospects. *Central Bank of Nigeria, Bullion.*Volume.30, 3

Neville, L. (2010). Decline and fall. *Global Finance January.*

Onwioduokit, E. A. (2008). Investing Africa's External Reserves in Africa: Issues, Challenges and Prospects. *Bullion,* 32, 4

Oputa, N. C. (1997). Determinants of Currency Composition of External Reserves in Nigeria: An Empirical Exploration. *CBN, Economic & Financial Review,* 35, 1, March.

Petroleum Act (1969). Joint Venture Exploration.

Rodrik, D. (2006). The Social Cost of Foreign Exchange Reserves. National Bureau of Economic Research, Working Paper Series w11952

Stekler, L. and **Piekarz, R.** (1970). Reserve Asset Composition for Major Central Banks. Oxford Economic Papers. No.22.June.

Stephen, N. M. and **Osagie, E.** (1978). *A textbook of Economics for West African Student.* Ibadan: University Press,

Stiglitz, J. (2010). Freefall: America, free markets, and the sinking of the world economy. W.W.Norton & Company, Inc.UK.

Varian, H. R. (2003). Economics of Information Technology' in Academic Papers and Books, 2004 and Earlier Non Technical Paper. World Bank, 2007.

Williams, M. V. (2005). Foreign Exchange Reserves: How Much is enough? Text of the Twentieth Adlith Brown memorial Lecture delivered at the Central Bank of Bahamas, Nassau, November. *http/ www.bis.org/review/r060123c*